U.S. Department of the Interior
Office of Inspector General

AUDIT REPORT

SELECTED ACTIVITIES OF THE ROYALTY MANAGEMENT SYSTEM, MINERALS MANAGEMENT SERVICE

REPORT NO. 96-I-1255
SEPTEMBER 1996

United States Department of the Interior

OFFICE OF THE INSPECTOR GENERAL
Washington, D.C. 20240

OCT 16 1996

MEMORANDUM

TO: The Secretary

FROM: **Wilma A. Lewis**
Inspector General

SUBJECT SUMMARY: Final Audit Report for Your Information - "Selected Activities of the Royalty Management System, Minerals Management Service" (No. 96-I-1255)

Attached for your information is a copy of the subject final audit report. The objective of the audit was to determine whether the Minerals Management Service had reasonable assurance that oil and gas production was reported accurately for royalty determination purposes.

The Minerals Management Service had not been successful in securing compliance by all oil and gas operators and lessees (reporters) with the requirements to accurately report the sale and production of oil and gas from Federal and Indian leases. Remedies contained in the Code of Federal Regulations, such as late payment charges and civil penalties, had not provided an adequate deterrent to ensure compliance by all reporters because prescribed interest rates were low and it was difficult for the Service to implement the penalties effectively. Also, the Service had not assessed a fee to recover its costs of resolving reporting discrepancies. As a result, the Service's volume comparison process, which compares sales volumes reported on the production report with sales volumes reported on the royalty report, generated more exceptions (differences) than the Service could resolve. Although the Service established a dollar threshold below which it did not research or resolve the exceptions, it has been unable to reduce the backlog of unresolved exceptions over the threshold, which we estimate to have a royalty value of over $21.2 million.

In its response, the Service agreed to review staffing levels in accordance with our recommendation that vacant positions should be filled to resolve all cost-effective exceptions. In addition, the Service stated that it agreed "in principle" with our recommendations relating to the pursuit of penalty assessments for substantial underpayment of royalties and the recovery of costs associated with the detection and correction of misreporting. However, the Service stated that it was deferring corrective action on these issues until it could analyze recent legislation.

If you have any questions concerning this matter, please contact me at (202) 208-5745 or Mr. Robert J. Williams, Acting Assistant Inspector General for Audits, at (202) 208-4252.

Attachment

C-IN-MOA-005-94(c)

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

SEP 30 1996

AUDIT REPORT

Memorandum

To: Director, Minerals Management Service

From: Robert J. Williams Robert J. Williams
Acting Assistant Inspector General for Audits

Subject: Final Audit Report on Selected Activities of the Royalty Management System, Minerals Management Service (No. 96-I-1255)

INTRODUCTION

This report presents the results of our review of the Minerals Management Service's accounting for oil and gas production. The audit objective was to determine whether the Service had reasonable assurance that oil and gas production was reported accurately for royalty determination purposes.

BACKGROUND

On January 12, 1983, the Congress enacted the Federal Oil and Gas Royalty Management Act of 1982 to ensure that all oil and gas originating on public and Indian lands and the Outer Continental Shelf are properly accounted for. The Act requires the Secretary of the Interior to establish comprehensive inspection, collection, and fiscal and production accounting and auditing systems to accurately determine and collect oil and gas royalties. The Service's Associate Director for Royalty Management is responsible for the development and implementation of these systems. The Service is also responsible for monitoring lease production on the Outer Continental Shelf. The Bureau of Land Management, through its Inspection and Enforcement Program, monitors production on onshore Federal and Indian leases.

Title 30 of the Code of Federal Regulations requires Federal and Indian oil and gas lessees and operators (reporters) to report, in an accurate, complete, and timely manner, the production and sale of oil and gas from leases and to pay the Government a royalty based on a rate established in the terms of the lease. To help enforce compliance with this and other Royalty Management Program requirements, Section 109 of the Federal Oil and Gas Royalty

Management Act of 1982, as amended, authorizes the use of civil penalties for violations of certain provisions of the Act, including penalties for willful preparation, maintenance, or submission of false, inaccurate, or misleading reports, notices, affidavits, records, data, or other written information. In addition, the Code (30 CFR 216.40 and 218.40) states that assessments may be imposed for each production or royalty report[1] which is not received by the Service by the designated due date or which is completed incorrectly.[2] However, these regulations do not address assessments on discrepancies between the sales volumes reported on the production report and on the royalty reports.

The Service's Royalty Management Program developed the Auditing and Financial System to collect information regarding sales and royalty payments and the Production Accounting and Auditing System to collect information regarding production reporting. The two systems incorporated edit routines that identified errors such as missing or incomplete information, illegible reports, mathematical errors, and invalid codes. These errors, for which a reporter could be assessed a $10 fee, are designated "fatal errors," and they prevent further processing of the document. After the corrected data are entered into the systems, the Service performs a volume comparison, which compares sales volumes reported by operators on the Monthly Report of Operations with the sales volumes reported by payers on the Report of Sales and Royalty Remittance. Any differences in these reports are classified as volume exceptions and are processed by the Service to identify royalty underpayments. A fee is not assessed for processing these volume exceptions.

The Service's budget for fiscal years 1993 and 1994 was $196.5 million and $193.7 million, respectively. The budget for the Royalty Management Program, which is responsible for most royalty compliance activities, was about $65.8 million and $68 million, respectively, for the same two periods. During calendar years 1993 and 1994, the Service collected and disbursed approximately $8.4 billion in revenue. During the same period, the Service's compliance efforts resulted in additional royalty collections of about $496 million, which was composed of the following: (1) audit collections of $408 million; (2) sales volume comparison collections of $43.8 million; (3) interest assessments for royalties that were underpaid or that were paid late and lease term exceptions of $38.4 million; (4) Automated Allowance Tracking and Outer Continental Shelf Improper Recoupments of $4 million; and (5) liquidated damage assessments for late, missing, and erroneous reports of $1.8 million.

SCOPE OF AUDIT

We reviewed the Royalty Management Program's oversight of oil and gas production and sales volume reporting for fiscal years 1993, 1994, and 1995. In addition, we reviewed offshore oil and gas production verification activities for the same period. We are issuing a separate report on automated systems that support the Royalty Management Program.

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[1] A report is defined in the regulations as each line of information required on a production or royalty form.

[2] The final rule, published in the "Federal Register," for assessments for incorrect or late reports and failure to report defines an incorrectly completed report as one that fails to pass the system edits.

Our review was performed during September 1994 through September 1995 at the Service's Royalty Management Program office and one Service contractor's office, both in Lakewood, Colorado. Site visits were made to the Outer Continental Shelf Gulf of Mexico Regional office in Metairie, Louisiana, and the Pacific Regional office in Camarillo, California. Our audit was conducted in accordance with the "Government Auditing Standards," issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances.

We also reviewed the Secretary's Annual Statement and Report to the President and the Congress for fiscal year 1994, required by the Federal Managers' Financial Integrity Act of 1982, and determined that there were no reported weaknesses related to the objective and scope of our audit. However, the Service completed a review relating to royalty verification activities in 1994 that identified control weaknesses related to the scope of this audit. These weaknesses, as stated in the Control Evaluation Report, were as follows: (1) "Staffing may be insufficient to assure that all cost-effective exceptions are pursued"; (2) "Case resolution period substantially lengthened by operators' failure to timely respond to exception letters"; (3) "Some payers may be intentionally circumventing the AFS-PAAS [Auditing and Financial System - Production Accounting and Auditing System] volume comparison process"; and (4) "Old injection balance exceptions not resolved." While the Service did not consider these weaknesses to be material, Royalty Management Program personnel told us that they planned to take the corrective actions outlined in the report.

As a part of our review, we evaluated the system of internal controls to the extent that we considered necessary. The internal control weaknesses that were found are discussed in the Results of Audit section of this report. If implemented, the recommendations should improve the internal controls.

PRIOR AUDIT COVERAGE

During the past 6 years, the General Accounting Office has issued one report and the Office of Inspector General has issued three reports related to verifying oil and gas production or to making assessments for incorrect or late reports or failure to report as follows:

- The General Accounting Office audit report "Mineral Revenues, Progress Has Been Slow in Verifying Offshore Oil and Gas Production" (No. GAO/RCED-90-l93), dated August 31, 1990, concluded that 7 years after enactment of the Federal Oil and Gas Royalty Management Act of 1982, the Service did not have a fully operational program for verifying that all oil and gas production was accurately reported for royalty determination purposes. Subsequently, the Service implemented a Liquid Verification System to help ensure the proper reporting of oil and condensate measurements on offshore leases and a Gas Verification System pilot program to help ensure the proper reporting of gas production offshore.

- The Office of Inspector General audit report "Followup of Recommendations Concerning Selected Postlease Activities in the Outer Continental Shelf, Minerals

Management Service" (No. 90-40), issued in February 1990, concluded that the Service had not implemented a production verification system for offshore oil or gas, which was recommended in the original audit report. The Service subsequently implemented the Liquid Verification System to help ensure the proper reporting of oil and condensate measurements on offshore leases and the Gas Verification System pilot program to help ensure the proper reporting of gas production offshore.

- The Office of Inspector General audit report "Surety Bonds Issued in Lieu of Disputed Payments, Minerals Management Service" (No. 93-I-780), issued in March 1993, contained one recommendation that was applicable to our current audit. The recommendation stated that the Service Director should encourage the prompt payment of audit-identified royalty underpayments by assessing late payment penalties and administrative costs on all such payments. If necessary, according to the report, legislation should be submitted through the Department to obtain authority for such assessments. This recommendation was considered resolved based on the Service's response, which stated that it was already reviewing the feasibility of imposing such penalties and may propose authorizing legislation or rulemakings. This legislation was subsequently proposed by the Service but not enacted by the Congress.

- The Office of Inspector General audit report "Assessments and Appeals, Minerals Management Service" (No. 93-I-1174), issued in June 1993, stated that information provided by payers was often incorrect and that, as a result, the Service generated inaccurate bills which subsequently had to be corrected manually. The report concluded that the Service should require payers to submit accurate information and that payers should be assessed penalties for submitting incorrect information. The report also stated that the Service needed to improve its computerized system, which generates assessments. However, the report did not make any specific recommendations regarding payer-submitted information.

RESULTS OF AUDIT

The Minerals Management Service has not been successful in securing compliance by all lessees and operators (reporters) with the requirements to accurately report the production and sale of oil and gas from Federal and Indian leases. Service instructions require that production and sales volumes be reported accurately and timely, and the Code of Federal Regulations provides remedies, such as late payment interest charges (30 CFR 218.54) and civil penalties (30 CFR 241.51), for those situations where royalties have been underpaid. However, these remedies have not provided an adequate deterrent to ensure compliance by all reporters because the prescribed interest rates were low and it was difficult for the Service to implement the penalties effectively. Further, the Service did not assess a fee to recover its costs of resolving discrepancies that resulted from inaccurate reporting. This has resulted in a large number of incorrect reports, which the Service must research. In that regard, the Service's volume comparison process, which compares sales volumes reported on the production report with sales volumes reported on the royalty report, generated more exceptions than the Service could resolve. This led to the establishment of a dollar threshold

below which the Service did not research or resolve the exceptions. We estimate the royalty value of these unresolved exceptions below the threshold to be approximately $1.7 million annually. The Service has also been unable to reduce the backlog of unresolved exceptions that are over the threshold, which we estimate to have a royalty value of over $21.2 million. Also, the Service has not recovered any of the $2.1 million it spends each year to resolve the discrepancies in reported sales volumes.

Sales Volumes Exceptions

The Service compares oil and gas sales volumes reported on the monthly production reports with the sales volumes shown on the monthly royalty reports. These comparisons are normally performed about 6 months after the original reports are required to be submitted. For each month during fiscal years 1993 through 1995, this system made approximately 25,000 comparisons and identified over 8,000 exceptions. The Service sorted these exceptions into three categories based on the estimated royalty value of the exception. The estimated royalty value was determined by multiplying the difference in the sales volumes by the estimated sales price and royalty rate.

The first category, about 3,000 per month, consists of those exceptions that show a higher sales volume on the royalty report than on the production report and appear to be overpayments. According to Service officials, the Service performed no further review of these exceptions because it does not generally research overpayments. Based on our review of 71 overpayment exceptions, we believe that many of the apparent exceptions were actually caused by the Service’s application of an incorrect gas plant conversion factor.[3] When we used the corrected factor provided by the Service, most of the exceptions were eliminated or reduced substantially. However, we found that eight of the exceptions appeared to be underpayments, with an apparent exception value of $162,000. Since the Service does not research and resolve apparent overpayments, no efforts were initiated to try to recover these apparent underpayments.

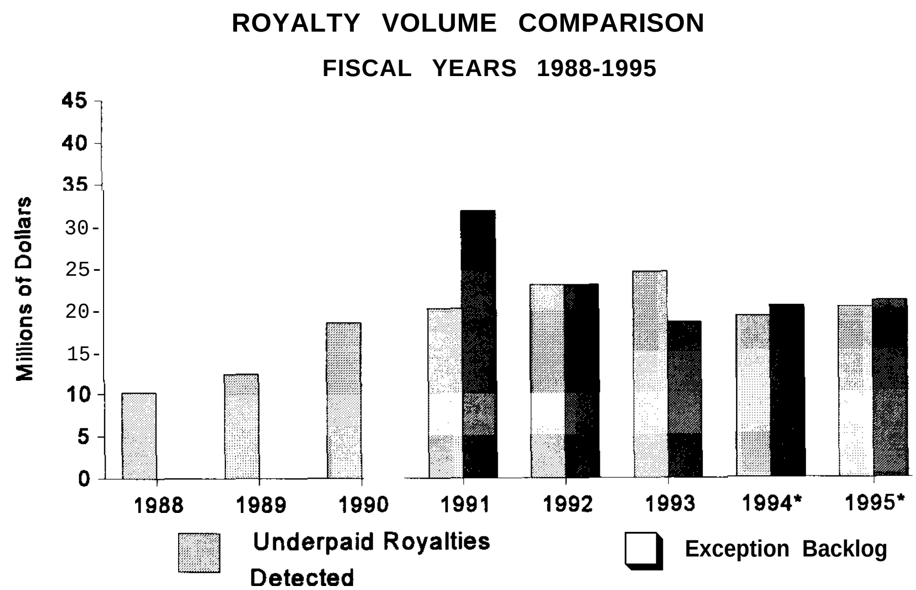
The second category, about 3,000 per month, consists of those exceptions in which the estimated additional royalties recovery falls below a dollar threshold specified by the Service. Service officials said that these exceptions were eliminated from further analysis because the Service did not have the resources to research and resolve them. However, the Service estimated that about 2,400 of these 3,000 exceptions would be cost effective to pursue. Based on our review of these eliminated exceptions, we estimated annual uncollected royalties at approximately $1.7 million.

The final category, 2,000 per month, consists of those exceptions in which the established dollar threshold is exceeded, and these exceptions are either reviewed and resolved or added to a backlog inventory. During fiscal years 1993 and 1994, the Service spent about $4.3 million to research and resolve these exceptions and recovered over $43.8 million in

[3]Gas plant factors represent one or more percentages that are applied to natural gas after extraction at gas plants to determine the production volume used for royalty determination purposes.

underpaid royalties. On the average, this rate of recovery produced $10 of additional revenue for each $1 expended. Although the Service volume comparisons detect differences in amounts reported, they do not verify the accuracy of reported amounts. For example, during the same 2-year period, the Service's auditing activities identified and recovered an additional $34 million in underpaid royalties attributable to misreported production and sales volumes.

As of September 27, 1995, the Service had a backlog of 18,534 high dollar value unresolved exceptions. We estimated that this backlog would require more than 9 months to resolve if no new exceptions were generated. However, the backlog of unresolved exceptions continued to increase because the number of monthly exceptions requiring processing exceeded the Service's processing capability. We estimated the potential value of the backlogged unresolved exceptions at $21.2 million. The number of these exceptions has increased steadily over the previous 2 years, as shown in the following graph:



*As stated in the Service's report to the Congress "Report of Royalty Management, FY 1994," the decline is attributable to a reduction in personnel available to perform the comparison.

When a sales volume discrepancy is detected, a Service analyst reviews the production and sales reports and attempts to identify the reporters that underreported the sales volumes. Once this review is accomplished, the analyst notifies the reporter by letter of the

discrepancy and requests a response explaining the volume difference within 30 days. If the required documentation is not received within 60 days, the analyst prepares an Order to Comply letter, which directs the reporter to provide the information within 30 days. Frequently, information provided during this process will indicate that another reporter is responsible for providing the data. When this occurs, the process starts over. If the reporter does not respond to the Order to Comply and other informal contacts within 2 to 3 weeks after the end of the Order to Comply response period, a Notice of Noncompliance may be issued. This notice is issued because the reporter did not respond to the Order to Comply, not because volumes were misreported. The Notice of Noncompliance normally takes 2 to 3 weeks to process before it is issued. If the reporter responds to the Notice of Noncompliance and provides the requested information within a 20-day abatement period, no penalty is imposed. If the response indicates that another reporter is responsible for submission of the appropriate records, the process starts over. If the reporter does not provide the information requested, a penalty maybe assessed for failing to comply with the Notice of Noncompliance. In many cases, the exception resolution process can take up to 2 years before the reporter provides the information necessary to resolve the volume exception. As of September 27, 1995, 3,647 (31 percent) of the 11,656 open cases were more than 1 year old.

In 1994, the Service conducted a review of royalty verification. As part of this review, Service analysts and technicians who were surveyed stated that compliance measures (for example, written orders) were too cumbersome and did not ensure that compliance would be timely. Program personnel from the Service, as well as from the Bureau of Land Management, told us that many of the companies with high reporting discrepancy rates did not consider the accurate reporting of production or sales volumes a high priority. These officials said that industry problems such as high personnel turnover rates, internal data processing problems, and inadequate company training contributed to the incorrect reporting.

Measures for Improving Reporting Accuracy

We concluded that the Service needs stronger enforcement measures to improve reporter compliance with the requirements to report sales volumes accurately and timely. While the Service can charge interest on underpaid royalties and assess a penalty if a reporter fails to comply with a Notice of Noncompliance, these measures have not resulted in any substantive decrease in the 33 percent sales volume comparison exception rate. Furthermore, the Service has attempted to use other means to improve the accuracy of reporting, such as providing training to the operators and payers, requesting additional resources to work on volume exceptions, and using liquidated damage assessments for edit errors. These measures have reduced the number of edit errors but have not made appreciable changes in the accuracy of reported sales volumes,

Penalties. Section 109 of the Federal Oil and Gas Royalty Management Act authorizes the use of civil penalties when a lessee, operator, revenue payer, reporter, or other authorized person fails or refuses to comply with any statute, regulation, order, or term of the lease. Penalties may be assessed after due notice of violation has been given and the violator fails

or refuses to comply. If a reporter complies with the issued notice (normally within 20 days), the Service cannot assess a penalty, During the past 3 fiscal years, the Service issued only 12 Notices of Noncompliance for volume exceptions and assessed four penalties, collecting only one penalty of $37,500. During the same period, collections of underpaid royalties from the Service's total compliance efforts were in excess of $500 million. Because of the lengthy and time-consuming procedures required before a penalty can be assessed, the Service has not imposed many penalties as a means to deter the misreporting and underpayment of royalties.

Interest Assessments. Title 30 of the Code of Federal Regulations authorizes the Service to assess interest to a payer for any underpayments that result from late or underreported royalties. Interest is assessed for the time the payer has delayed payment to the Government. The interest assessment is based on a rate established by the Internal Revenue Code (26 U.S.C.), which in February 1996 was 9 percent. In a 1994 discussion paper attached to proposed legislation amending the Federal Oil and Gas Royalty Management Act of 1982, the Service stated in part:

> The interest rate, established by statute, is currently considerably less than the cost of capital for most, if not all, Federal lessees. Therefore, underpayment today can be considered a cheap loan from the Federal Government. As a matter of public policy, it should be cheaper to pay correctly than to underpay.

Increased Staffing. In order to work all cost-effective exceptions, the Service estimated in 1994 that it would require 24 additional staff members to work volume exceptions. In 1995, the Service added six analyst positions to the Compliance Verification Division. However, according to Royalty Management Program officials, these positions are unfilled because of budgetary constraints.

Assessments for Liquidated Damages. The Code of Federal Regulations (30 CFR 216 and 218) authorizes the Service to assess $10 for each production and royalty report not received by the Service's designated due date and $10 for each report received by the due date but which is completed incorrectly. In the final rule published in the "Federal Register" for Title 30, Parts 216 and 218, of the Code, the Service defined an incorrectly completed report as "one that fails to pass the system edits." The Service has assessed reporters various amounts for incorrectly completed reports detected by the automated edit routines. The use of assessments has been effective in reducing fatal error rates from 5.4 percent in 1990 to less than 3 percent in 1995. However, the Service did not assess liquidated damages for sales volume discrepancies because these reporting inaccuracies passed the system edits.

Using 1994 cost data, we found that even if the Service had assessed $10 for each volume exception researched and resolved, it would have recovered only $240,000 of the $2.16 million in costs that it incurred to resolve these deficiencies (2,000 deficiencies researched and resolved each month X 12 months = 24,000 X $10 = $240,000), or a net underrecovery of about $1.9 million. Based on this example, we estimated that the assessment amount

would need to be increased to about $90 for each volume exception for the Service to recover all of its operational costs associated with researching and resolving volume exceptions ($2,1 60,000 ÷ 24,000 = $90). We believe that a $90 assessment in this instance would substantially reduce reporting deficiencies and allow the Service additional time to research and resolve the exceptions that it currently excludes.

In a September 12, 1995, press release, the Director of the Service announced that as of October 1, 1995, the Service would no longer assess companies for the late filing of royalty and production reports or report errors unless the companies' overall monthly edit error rate exceeded the average monthly error rate for the fiscal year 1995 level. Royalty Management Program personnel told us that the assessments for liquidated damages may be eliminated by legislative action. Such language was included in the Budget Reconciliation Act, which was passed by the Congress but vetoed by the President in December 1995. These officials said that they believed passage of similar legislation would take away their authority to assess reporters that submitted erroneous information for the costs of correcting the reporting errors and prevent assessments for volume exceptions.

Training. The Service provided extensive training to many of its reporters on the preparation of production and royalty reports, prepared and provided comprehensive reporter handbooks, conducted special reconciliation projects, and visited many of the companies to explain production and royalty reporting procedures. During fiscal years 1993 and 1994, the Service provided 124 free training sessions attended by over 4,000 participants.

While we believe that the volume comparison program has had a positive impact, additional measures are needed. In this regard, we agree with Service officials who believe that legislative authority to impose penalties for companies that significantly underpay their royalties would promote voluntary compliance and place responsibility for correct reporting with the reporters. The implementation of penalties is consistent with the recommendation of the National Performance Review, which stated that the Department should submit legislation similar to provisions of the Internal Revenue Service to enable penalties to be assessed for substantial underpayment. Such legislation was submitted in 1993 but was not enacted. This method of implementation is also consistent with our recommendation to assess late payment penalties on royalty underpayment, as stated in our report" Surety Bonds Issued in Lieu of Disputed Payments, Minerals Management Service" (No. 93-1-780), which was issued in March 1993.

Improved compliance would reduce the number of exceptions that require processing each month. The reduced work load would also allow the Service to utilize existing resources to reduce the estimated $21.2 million backlog of unresolved exceptions, collect the estimated $1.7 million of underpaid royalties associated with the dollar value exceptions falling below the threshold, process the apparent overpayment exceptions, and improve the accurate and timely collection of royalties.

Recommendations

We recommend that the Director, Minerals Management Service:

1. Pursue the submission of legislation through the Department which would authorize penalties to be assessed for substantial royalty underpayment, such as those that misreport sales quantities and that cause royalties to be underpaid significantly.

2. Pursue the development of regulations providing for the full recovery of costs for detection and correction of the misreporting of production and sales volumes if attempts to obtain legislation authorizing penalties for underpayment are not successful.

3. Pursue funding to fill the vacant positions in the Compliance Verification Division so that the backlogged cost exceptions can be processed.

Minerals Management Service Response and Office of Inspector General Reply

In the June 6, 1996, response (Appendix 2) to the draft report from the Minerals Management Service's Director, the Service stated that it "agree[d] in principle" with Recommendations 1 and 2 and "agree[d]" with Recommendation 3. The Service stated that it would defer action on Recommendations 1 and 2 until it could assess the impact of a bill that was under consideration by the Congress which could impact the Service's ability to assess lessees for incorrect reporting. Subsequent to the Service's June 6 response, the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 was enacted. Since the legislation referred to by the Service has been enacted, we request that the Service respond to Recommendations 1 and 2, which are unresolved, and provide additional information for Recommendation 3 (see Appendix 3).

Additional Comments

The Service stated that it believed our report was "incorrect in stating that 'not all volume discrepancies are detected by the Service's volume comparison.'" Based on that statement, we clarified our report to indicate that the Service's volume comparison detects all differences in sales reported on the Monthly Report of Operations submitted by the operator and the sales volumes reported on the Sales and Royalty Remittance Report submitted by the payer (frequently the same company). We also modified the report to reflect that this comparison does not verify the accuracy of the sales quantities reported; that is, if incorrect but equal sales figures are reported on each of the reports or if equal amounts of sales are missing from each of the reports, no exception will be generated by the comparison. Consequently, the misreporting of sales quantities can and does go undetected by the Service.

The Service also stated that it agreed that some underpayments of royalties occurred because of incorrect gas plant factors, as indicated in our report, but that the erroneous reporting was not “prevalent enough to warrant diverting FTE [full-time equivalent employees] from working the identified underreported volumes to research these problems.” We agree that under the current situation, resources should not be diverted to researching this area, which is why we did not recommend that the Service take such action.

The Service also stated that it would “not support” the conclusion that “expending additional Federal resources to detect and correct reported volume discrepancies is the least effective of the Service’s compliance options.” We have revised the report to make clear that, in making this statement, we did not intend to diminish the accomplishments of the volume comparison program. Rather, we wanted to emphasize that the most cost-effective method of deterring substantial misreporting would be to assess liquidated damages, interest, or penalties against those in the industry that consistently reported erroneous sales data. We believe that this action would improve the accuracy of the reporting and therefore reduce the Service’s resource requirements to resolve differences in reported volumes.

APPENDIX 1

CLASSIFICATION OF MONETARY AMOUNTS

Finding Area	Potential Additional Revenues	Funds To Be Put To Better Use
Uncollected Royalties	$1,700,000	
Cost Recovery		$2,160,000

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

1996

Memorandum

To: Assistant Inspector General for Audits

For Through: Bob Armstrong Piet deWitt JUN - 6 1996
Assistant Secretary, Land and Minerals Management

From: Cynthia Quarterman Thomas A. Readinger
for Director, Minerals Management Service

Subject: Office of Inspector General Draft Audit Report C-IN-MOA-005-94(C) "Selected Activities of the Royalty Management System"

I appreciate the opportunity to respond to this draft report on our Royalty Management Program's production and royalty volume comparison process. We are in general agreement with the three recommendations in the report. I'm sending you our general comments on the audit findings and specific ones on the recommendations.

Please contact Bettine Montgomery at 208-3976 if you have any further questions.

Attachment

'96 JUN 12 P2:08

RECEIVED
OFFICE OF INSPECTOR GENERAL
IMMEDIATE OFFICE

MINERALS MANAGEMENT SERVICE RESPONSE TO DRAFT AUDIT REPORT "SELECTED ACTIVITIES OF THE ROYALTY MANAGEMENT SYSTEM MINERALS MANAGEMENT SERVICE"

Audit Agency: Office of Inspector General (OIG)

Audit Number: C-IN-MOA-005-94 (C)

GENERAL COMMENTS

We appreciate the opportunity to comment on this draft report which primarily addresses our production and royalty volume comparison process. We generally agree with the facts presented in this report. However, we offer the following information to clarify certain issues.

We agree that working the exceptions that fall under our current severity limits may recover an additional $1,700,000 annually. However, we need to assess this potential in comparison to other possible beneficial uses of additional FTE. Accordingly, we will assess your recommendation along with other compliance resource allocation issues in MMS' Compliance Reengineering Effort, a 2-plus year effort, initiated in April 1996, to evaluate and reengineer the existing royalty compliance process.

We believe the report is incorrect in stating on page 11 that "not all volume discrepancies are detected by the Services' volume comparison." The system checks over 117,000 lease/agreement/sales period/product combinations each month. It performs over 34,000 comparisons, detecting over 7,200 discrepancies each month. We believe that the cited $34 million in additional Audit collections attributable to misreported production and royalty volumes during the same two-year period, reflect volumetric issues occurring in periods prior to conversion to PAAS reporting. Thus, the AFS/PAAS comparison was not yet in place to identify and process volumetric exceptions. Audit collection statistics maintained by MMS are based on when the collection occurred, not on the production month.

The report also expresses concern over the fact that some overpayments, especially those involving processed gas and gas plant products are caused by the use of incorrect gas plant factors and are actually underpayments (page 10). The gas plant factor referred to is calculated based on data reported by lease operators and can indeed be distorted by erroneous reporting. We agree that such erroneous reporting occurs, but do not believe it is prevalent enough to warrant diverting FTE from working the identified underreported volumes to research these problems.

Page 18 further asserts that "expending additional Federal resources to detect and correct reported volume reporting discrepancies is the least effective of the Service's compliance options." We cannot support this conclusion. In fact, the pursuit of such volume discrepancies has resulted in nearly $173 million in additional royalty collections since inception, a cost-

benefit ratio of more than 10 to 1 with a consistent reduction in the number of erroneous exceptions detected each month. We believe these facts conclusively demonstrate that expending additional Federal resources to detect and correct reporter volume reporting discrepancies is a very effective method of achieving compliance with royalty reporting and payment requirements.

COMMENTS ON RECOMMENDATIONS

1. Pursue the submission of legislation through the Department which would authorize penalties to be assessed for substantial royalty underpayments such as those that misreport sales quantities and cause royalties to be underpaid significantly.

AGREE IN PRINCIPLE. However, MMS believes this recommendation is inappropriate to pursue at this time for the reasons expressed regarding recommendation 2.

2. Pursue the development of regulations providing for the full recovery of costs for detection and correction of the misreporting of production and sales volumes if attempts to obtain legislation authorizing penalties for underpayments are not successful.

AGREE IN PRINCIPLE. A legislative bill is currently under consideration by the Congress which may impact the MMS's ability to assess lessees for incorrectly reporting. We feel that until this legislative initiative is concluded, it would be an unproductive expenditure of resources to pursue this recommendation. Furthermore, we feel that additional analysis needs to be done to determine whether the cost of designing, implementing, and maintaining the assessments approach envisioned by the draft report would equal or exceed the benefits to be derived.

3. Pursue funding to fill the vacant positions in the Compliance Verification Division in order to resolve all cost-effective exceptions.

AGREE. The MMS is reviewing staffing levels and opportunities in this area. If additional finding is required, it will be requested.

STATUS OF AUDIT REPORT RECOMMENDATIONS

Finding/Recommendation Reference	Status	Action Required
1 and 2	Unresolved	Respond to the recommendations, and provide an action plan that includes target dates and titles of officials responsible for implementation.
3	Management concurs; additional information needed	Provide an action plan that includes target dates and titles of officials responsible for implementation.

ILLEGAL OR WASTEFUL ACTIVITIES
SHOULD BE REPORTED TO
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Arlington, Virginia 22210

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